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Changing Political-Economic Environment

In 1971, two Presidential reports pointed out the sea changes taking place in the international economic environment and their implications for the United States. Both reports, "The United States in the Changing World Economy" (by Peter G. Peterson) and "US International Economic Policy in an Interdependent World" (by a committee chaired by Albert L. Williams) emphasized:

-- The increased economic competition from Western Europe and Japan as a result of their narrowing of the economic and technology gap with the United States.

-- The much greater attention policymakers must pay to international economic matters in making their domestic decisions as a consequence of the growing global economic interdependence.

-- The pressing need to alter international economic arrangements and to strengthen the domestic economy in order to meet these two challenges.

In essence, the two Presidential reports indicated the ending of a quarter of a century characterized by extraordinary economic progress and an unusual degree of cooperation among industrial countries on economic matters. The successful 1950-73 era reflected a unique set of fortuitous circumstances. The post - World War II environment provided an enormous potential for rapid economic expansion. Western Europe and Japan possessed the considerable human skills needed to restore their economies. The United States meanwhile emerging from the war with an extremely strong economy could

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afford to finance the development of the war-torn industrial states and allow them to grow rapidly by exporting to an open US market.

The governments of the United States and other industrial countries could easily pursue these growth policies because they served both their national and the common interest of all parties. Efforts by Western Europe and Japan to achieve rapid economic growth were strongly supported by the United States because it met its number one security goal of containing Communism and because it meant the reestablishment of traditional markets for US goods. The momentum of the dynamic growth lasted until the early 1970s and provided sufficient new jobs to absorb workers put out of work by technological advances and those just entering the labor force. Governments also found they could afford to meet the increased demands for new social welfare and environmental programs.

These extraordinary circumstances could not last mainly because:

-- The economic and technological gap between the United States and other major industrial countries had narrowed to the point where it was no longer a major force in the post - World War II expansion.

-- The United States no longer could afford or was politically willing to allow other countries to depend as much as they had on the US market for boosting their economic growth.

-- The rapidly rising demand for oil as a cheap source of energy had to end because of supply constraints.

-- The good years had eroded the competitive vigor of the private economy, generated large and costly government programs, and institutionalized inflation. Workers learned to press for higher wages to compensate for rising prices, and firms found it easy to pass on higher wages to the consumer.

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These changing conditions created the troublesome post-1973 years for the industrial world. Economic growth slowed markedly, unemployment jumped, and inflation tenaciously remained at high levels. In addition, the unique cooperation that resulted from the benevolent use of US post - World War II power was replaced by the normal state of affairs, where it is necessary to mesh conflicting national policies. The need to alter attitudes made matters worse. Countries that had become accustomed to policies and practices that had served them successfully for so long naturally were reluctant to abandon them. Some developed countries, especially Japan, were resistent to opening their markets to foreign goods, and the United States found it difficult to subject its domestic economic policies to balance of payments discipline and other foreign concerns, such as high interest rates.

Although adjusting to the new circumstances has been a wrenching process, the industrial world has done remarkably well. Their economies as a group expanded at 2.5 percent annually, a rate, while half that of the previous two decades, is rather reasonable by historic standards. More important, an economic collapse was averted and political-social tensions were contained.

Much of the credit for minimizing the adjustment pains is due to the durable political-economic system inherited from the 1950-73 era. On the national level, the most important achievement has been the fact that the great majority of people in the developed world and in some less developed countries have acquired a substantial stake in the survival of their countries' political-economic system. The extensive income security systems put in place in the pre-1973 era were expanded, reducing the hardships inflicted by unemployment. On the international level, we have seen the steady development of institutions, informal linkages, and codes of conduct merging into a new kind of equilibrating structure. Although the cooperation

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has been far from perfect, the process has at a minimum greatly inhibited countries from initiating actions that could severely hurt other countries or impair the international order. Measured against this criterion, the international economic structure that has evolved since World War II has been highly effective. The world economy was able to adapt remarkably well to the shock of the massive OPEC price increase in 1973-74. By contrast, in the interwar period of the 1930s, dislocations of far more modest proportions led to widespread financial default, rampant protectionism, and an economic depression.

The policy process that the two Presidential reports helped initiate and the impact of market pressures produced changes in international economic arrangements that were highly useful in coping with the economic troubles of the 1970s, especially the OPEC shocks.

-- The replacement of the fixed exchange rate system with a more flexible regime allowed currency values to fluctuate with changing economic circumstances rather than have to wait for a political decision.

-- Elimination of controls on US capital flows in 1974 (later in some other industrial countries) helped provide a means of achieving the needed flows of petrodollars and at the same time provided US commercial banks with a major new source of earnings.

-- Progress toward a more open trading system under the MTN (Tokyo Round) was instrumental in containing the periodic buildup in protectionist pressures.

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-- More frequent and more intimate exchange of views through the OECD, BIS, IMF, and economic summits etc. produced a process that constrained countries from taking actions that could hurt others.

Among the industrial countries the US economy did rather well in dealing with the new economic circumstances. The US growth of real output exceeded or at least matched all other industrial countries except Japan. The sharp appreciation of foreign currencies against the dollar in the 1970s created the exchange rate illusion that other industrial countries were still gaining on the United States. In fact, the exchange rates were merely catching up with the real changes that had occurred earlier. In real terms, the United States maintained its relative economic power position through the 1970s.

The US economic gains came mainly from putting people to work rather than from increasing their productivity. In large part this reflected the much more rapid growth in its labor force than other industrial countries (except Canada). Persons in the United States turning 18-25 years old rose much more rapidly than elsewhere. The United States also moved from a position of having one of the lowest proportions of females employed in the late 1960s to having the highest proportion by the late 1970s. Finally, the United States absorbed the largest rise in immigrant workers.

The Challanges of the 1980s

During the next ten years, the US economy will be confronted with powerful forces of structural change as pervasive as those it faced in the past decade, although quite different. Rapid advances in technology, sweeping shifts in consumer demand, major alterations in patterns of energy use, and significant reversals in demographic trends are all part of the dynamic process to which industrial societies must continually adjust. A display of

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the changing nature of these issues since World War II and a glimpse at the future are shown in figure 1. In this adjustment process, those who stand to benefit from change are forever at odds with those who stand to lose. The former seek to alter the rules and structures, while the latter want to preserve the status quo. The problem for government is how to make the needed structural adjustments politically palatable while minimizing their socially disruptive consequences.

As we have seen, the ability of the industrial countries to tolerate the adjustment process depends to a large measure on the pace of economic growth. For the next five to ten years, it is certainly possible that economic growth probably will rise faster than during the 1970s, since significant progress has been made in coming to grips with oil market stringencies, inflationary pressures, and surging government spending (mainly the United States). A return to the halcyon pre-1973 era, however, is highly unlikely, either in terms of rapid economic growth or the low level of political frictions. The reappearance of the highly unusual set of circumstances that characterized those years is very remote, as is a reemergence of US global dominance in military, economic, political and technology matters. At best, a sustained growth rate of some 3.5 percent seems most plausible during the 1980s. Such a one percentage point rise above the level of the 1970s would go a long way in reducing unemployment and ameliorating social and political tensions stemming from economic related adjustments.

Achieving this higher level of economic growth rests more on the success of US efforts than at any time since the 1950s. The United States is the only developed country with a major economic recovery program underway. Although it no longer is the dominant economic power, the United States remains the

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preeminent one. A rapidly growing United States still provides considerable market opportunities for other countries in terms of size and openness. Western European nations will likely lag in making the difficult choices needed to energize their economies. Their problems are only now just beginning to be recognized in the political realm. Their leaders face many more barriers to change than elsewhere in the industrial world, and Europeans tend to place greater value on stability than growth. The Japanese could help spur economic growth if they were to quickly open up their markets to foreign competition. But the chances of this occurring are low, because many of their import barriers are deeply imbeded in social-cultural practices.

Many Roads to Adjustment

The way a society adjusts to secular change is much less a matter of its conscious choice than it is a function of its cultural-institutional makeup. There is no right way or wrong way, no single magic formula of social organization for coping successfully with change. For the most part, we are talking not about an "industrial strategy," but a set of entrenched conditions. It may be tempting to single out some particular set of policies or approaches on some facet of a country's institutions and to present these as success indicators or exemplars for other countries to emulate. But such single elements neither typically stand on their own when removed from their indigenous social context nor lend themselves readily to modification through social engineering.

Among the elements often cited as "explaining" a country's industrial dynamism and successful adjustment to change are such things as the way government interacts with the private sector, the manner in which industry is structured, the emphasis put on welfarism, and the amplitude of the consumer

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savings rate. But the evidence on the separate or collective impact of these and other elements is by no means clear. All that can be said is that industrial societies differ in their institutions, approaches, and policies in these matters. When they do try to replicate each other's solutions, they often find that what is good for one is not necessarily appropriate for the other. While the long-term trend toward internationalization of production may well narrow the differences among countries, the differences are likely to remain substantial for some time.

The differences range over a wide spectrum. Some examples:

-- Role of government. Involvement of government with the private sector is pervasive in Japan and significant in Western Europe, but quite limited in the United States. Similarly, cooperative interaction among big government, big business and big labor is extensive in Japan and well developed in most West European states while in the United States the relationship among the three groups has been traditionally adversarial. Hostility, however, is beginning to break down, with the growing awareness in the United States that a community of interest exists among them.

-- Industrial organization. US industrial advances and technological gains depend far more on innovations by small and medium-sized firms than in Japan, where huge, well-established conglomerates seek to play the same role.

-- Emphasis on welfarism. Both Europe and Japan are more inclined than the United States toward preserving internal social stability--e.g., by providing income maintenance--and toward cushioning their industries against disruptive change--e.g., by cartelizing or nationalizing enterprises in distress. European countries work

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mainly through regulation, such as laws that restrain layoffs, while Japan adheres to less formal practices, such as the institution of "lifetime employment." Japan's pursuit of social stability policies has also been an important factor in insulating the Japanese domestic market from foreign competition.

-- Methods of investment financing. US firms are heavily dependent for investment capital on corporate profits and equity financing, while other industrial countries--most notably Japan--rely more on a high rate of consumer saving as a source of investment funds. Whether the notoriously low US rate of private saving has become a serious impediment to future US growth, as is now widely claimed, is not clear. Historically, the US savings rate has always been low.

These divergent institutional approaches and practices do not add up to any coherent explanation of why industrial countries differ in the degree and quality of their economic dynamism and adaptability. It seems, rather, that the variations among them are attributable to some quite fundamental factors. For the United States, its very high degree of flexibility rests on an uniquely broad-based economy, a great diversity of political institutions, and a relatively unimpeded flow of labor, capital, and know-how. Japan's adaptability springs largely from its social homogeneity that permits a strong consensus among interest groups. European countries vary considerably from one to the other, but collectively their societies exhibit less resilience and greater resistance to change, largely as a matter of social culture and tradition, including lingering class hostilities and broad adherence to socialist principles.

The fact that the US economy exhibited great adaptability in coping with

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change during the difficult decade of the 1970s, should give some comfort that it will adjust equally well to the stresses of the 1980s. The much-touted adjustment process, however--like the "unseen hand" of the market place--is invisible and unpredictable. Confidence in its efficacy, thus, is essentially an act of faith. For economists and public policy activists, however, faith is a rather shaky foundation. Fortunately, there are other, more tangible factors at work that bolster the proposition that the US economy should be doing quite well by the mid-1980s.

US Economic Resurgence

The high degree of flexibility and resilience that characterizes the US economy will be bolstered by a number of developments that should help to enhance the level of economic activity. Among these are:

-- In the important energy area, the United States has an enviably rich resource endownment and will be tapping these resources with unprecedented intensity. Already, as a result of technological breakthroughs in exploration and extraction and record drilling rates, the decade-long decline of the nation's oil reserves has been arrested and, since 1980, reversed. Also, given its relatively high per capita energy use, the United States has great potential for further conservation gains. If soft oil markets and sagging prices persist, these favorable developments will be slowed, but real energy costs are likely to remain high enough to maintain the momentum of development of abundant US coal resources and of conservation.

-- Capital spending, long repressed by uncertainties about future market demand, should surge once the economy turns up and interest

rates decline. The tax incentives already in place could even lead to a capital spending boom.

-- The present attractiveness of the US economy to foreign investors is likely to outlast a decline in interst rates. European apprehensions about political instability, stimulated especially by events in Poland and concern over domestic economic weaknesses, are likely to sustain the present large flow of equity capital to the United States. The Japanese, for their party, are already beginning to invest increasingly in the establishment of plants in the United States to assure market access in the event of US trade actions. The continued flow of foreign investment capital into the US economy will benefit the economy not only through job creation but also through increased competition and enhanced absorption of innovations in technology and management.

-- Demographic trends will induce the US economy to place greater emphasis on labor saving rather than the job creation it pursued in the 1970s. A shrinkage of new entrants into the labor force is already underway and will persist through the decade. Because this decline comes earlier and is more pronounced in the United States than in Europe, the United States will be in a better position to reduce unemployment and increase productivity. Gains in productivity will also result from this demographic trend because the average worker will be more experienced.

-- The service sector, which now accounts for more than 70 percent of the US labor force and for almost 90 percent of its growth, is a highly dynamic factor both in the United States and in the world economy. Indeed, a service transformation is taking place in the

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US economy, in which a new set of linkages is being established through the growth of "intergrative services" that interconnect firms, units of firms, and industries at different stages of production or in different locations. The distinction between goods and service industries is increasingly breaking down, as the two aspects merge with each other. The most dramatic expansion is now taking place in this integrative part of the service sector, that combines high technology with management/marketing know-how. In this "information economy" that marries computers and communications and that includes "software" of all types and a great variety of financial and diagnostic services, the United States is uniquely strong. It should be able to take excellent advantage in the 1980s of the lead it already enjoys in this rapidly expanding global market.

-- The US performance on the frontiers of technology should continue to be highly creditable, even though its earlier across-the-board preeminence has been at least selectively whittled away, as Western Europe and Japan narrowed the technology gap. But the challenge mounted by America's major industrial competitors is not overwhelming. The remarkable Japanese technology drive in some well-selected areas has forced US high technology industry--which had long felt secure in its dominance--to take foreign competition seriously. Major US firms are now developing strategies to capture leading positions in new areas and to regain market shares where they have slipped. The Japanese, for their part, will find it increasingly difficult to move from improving on and applying the inventions of others to developing epoch-making innovations that

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make possible whole new industries. They will also find it extraordinarily hard to replicate their innovative successes that have been concentrated in a few areas, across the much broader spectrum of technological activity that characterizes the United States. Finally, a major stumbling block for Japan will be the tough problem of moving from innovation in discrete areas of production to the integration of hardware and software into a customer-tailored service package. The 64K RAM chip success story, for example, may have been dramatic as a single accomplishment, but it represents only a speck on the large canvas of the computer-based knowledge industry.

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